In the Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-375

WILLIAM OTTE, TRUSTEE IN BANKRUPTCY OF FREEDOMLAND, INC., PETITIONER

v.

UNITED STATES OF AMERICA, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the district court is reported at 341 F. Supp 647. The opinion of the court of appeals (Pet. App. A) is reported at 480 F. 2d 184.

JURISDICTION

The judgment of the court of appeals was entered on June 8, 1973. The petition for a writ of certiorari was filed on August 29, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED[1]

1. Whether a trustee in bankruptcy is required to withhold federal taxes from payments of wage claims

---

[1] Petitioner also raises questions with respect to the proper treatment of New York City withholding taxes. We discuss only the issues pertaining to the United States.

made under Section 64(a)(2) of the Bankruptcy Act and to complete the appropriate information reports and returns with respect to the amounts withheld.

2. Whether the United States must file a proof of claim with respect to such withholding taxes.

3. Whether the withholding taxes on priority wage payments constitute first, second, or fourth priority debts under Section 64(a) of the Act.

STATUTES INVOLVED

The pertinent provisions of Sections 57, 63, and 64 of the Bankruptcy Act, 11 U.S.C. 93, 103, and 104, and Sections 3102 and 3401 of the Internal Revenue Code of 1954, 26 U.S.C. 3102 and 3401, are set forth at Pet. App. B, pp. 14a-17a.

STATEMENT

Freedomland, Inc., was adjudicated a bankrupt in August 1965. During the following six-month statutory period for filing claims in bankruptcy (see 11 U.S.C. 93(a)), 413 former employees of Freedomland filed claims for wages of $600 or less earned within six months prior to the filing of the bankruptcy petition and for which they were entitled to priority of payment under Section 64(a)(2) of the Bankruptcy Act, 11 U.S.C. 104(a)(2). These wage claims totalled approximately $80,000. As is its customary practice, the United States filed claims only for the taxes actually owing by the bankrupt at the time the petition was filed; the United States did not file claims for the withholding taxes which would become due if and when the priority wage claims were paid.

Petitioner, the trustee in bankruptcy of Freedomland, requested permission of the bankruptcy referee to pay

the priority wage claims without withholding any federal taxes. The referee authorized petitioner to make such payments without any withholding and further held that petitioner was not required to file with the Internal Revenue Service any tax returns or other reports with respect to those payments.

The government appealed from the referee's order to the United States District Court for the Southern District of New York, and that court reversed, holding that petitioner was required to withhold federal income and F.I.C.A. taxes from priority wage payments, to complete the appropriate information reports and returns with respect to such withholding, and to pay the amounts withheld to the United States as a fourth priority claim under Section 64(a)(4) of the Bankruptcy Act.[2] The court stated that the wage claims filed by the employees had been sufficient to apprise petitioner that federal withholding taxes would be due and payable, and therefore that the United States was not required to file claims with respect to such taxes during the six-month statutory period. The court of appeals substantially affirmed, but disagreed with the district court concerning the priority to be accorded the government's claim for withholding taxes, holding that such taxes are payable as second priority claims under Section 64(a)(2) of the Bankruptcy Act.

---

[2] The court held that, to facilitate bankruptcy administration, petitioner could meet the withholding requirement by keeping back a flat 25 percent of the gross wages instead of following the withholding tables set forth in Section 3402 of the Internal Revenue Code of 1954, 26 U.S.C. 3402. The government favors this practice.

DISCUSSION

1. The courts below correctly held that a trustee in bankruptcy must withhold federal income and F.I.C.A. taxes from priority wage payments and complete the appropriate information reports and returns with respect to the amounts withheld.

a. Sections 3402 and 3102 of the Internal Revenue Code of 1954, 26 U.S.C. 3402 and 3102, require every employer making payment of wages to deduct and withhold federal income and F.I.C.A. taxes.[3] Petitioner claims that he is not an "employer" and that priority wage claim distributions do not constitute the payment of "wages."[4] But the term "wages" is defined broadly for withholding purposes as "all remuneration for employment" (Sections 3121(a)(1) and 3401(a) of the Code) and "employer" is defined by Section 3401(d) as either the person for whom the employee performed services or, if such person does not have control of the payment of wages, the person having such control.

The priority wage claim distributions to the former employees of Freedomland constituted remuneration for past employment and petitioner was the person having control of such payments. Petitioner therefore was subject to the withholding provisions of the Code. Cf. *Social Security Board* v. *Nierotko*, 327 U.S. 358. Indeed, as the court of appeals below noted (Pet. App. A, p. 6a) and as petitioner concedes (Pet. 6), the

[3] Section 7701 of the Code further requires that the amounts so withheld be held by the employer in trust for the United States.

[4] Such distributions, of course, constitute taxable income to their recipients.

courts of appeals have uniformly held that priority wage claim distributions in bankruptcy are subject to withholding. *United States* v. *Fogarty*, 164 F. 2d 26 (C.A. 8); *United States* v. *Curtis*, 178 F. 2d 268 (C.A. 6), certiorari denied, 339 U.S. 965; *Lines* v. *California Department of Employment*, 242 F. 2d 201 (C.A. 9), certiorari denied, 355 U.S. 857; *In re Connecticut Motor Lines*, 336 F. 2d 96 (C.A. 3).[5]

b. It follows from petitioner's responsibility to withhold that he must also complete the appropriate information forms and returns with respect to the amounts withheld. See Sections 6011 and 6051 of the Code; *Nicholas* v. *United States*, 384 U.S. 678, 692-695.

2. The courts below also correctly held that the United States is not required to file a prior proof of claim with respect to withholding taxes on priority wage payments. Proofs of claim are required only with respect to "[d]ebts of the bankrupt * * *." Section 63(a) of the Bankruptcy Act, 11 U.S.C. 103(a). Withholding taxes on priority wage distributions are not debts of the bankrupt. The withholding taxes here at issue were not legally due and owing by Freedomland when it filed its bankruptcy petition; they became due only when the wages were actually paid by petitioner. See, *e.g.*, *In re International Match Corp.*, 79 F. 2d 203 (C.A. 2), certiorari denied *sub nom. Delaware* v. *Irving Trust Co.*, 296 U.S. 652. There was, therefore, no outstanding liability for the withholding taxes at

[5] Furthermore, we have been advised by the Internal Revenue Service that bankruptcy trustees generally consider themselves obligated to withhold federal income and F.I.C.A. taxes from priority wage payments and do so. The issue, therefore, is not frequently litigated.

the time of the bankruptcy adjudication; with respect to these taxes, there was no debt of the bankrupt for which a proof of claim could have been filed. Moreover, as the court of appeals below stated (Pet. App. A, pp. 11a-12a):

> * * * it might well be impossible for the Government to file a proof of claim, as it must do when the taxes are owing *by the bankrupt*, not the case here. The filing of the wage claims by the individuals constructively constituted a claim by the taxing authorities for withholding due by law. Other creditors are not misled, since the amounts claimed for wages include within them the amounts due to the taxing authorities. [Emphasis in original.]

The decision below on this issue conflicts with that of the Third Circuit in *In re Connecticut Motor Lines, supra,* which held that the government must file a proof of claim with respect to the withholding taxes on wages accrued but not paid prior to bankruptcy. The decision in *Connecticut Motor Lines* was based on the theory that such withholding taxes were, in a constructive sense, legally due and owing by the bankrupt. While that theory has not been followed in any other circuit, the underlying issue is one of substantial importance to the collection of revenues from bankrupt's estates.[6]

---

[6]While the district court below agreed with *Connecticut Motor Lines* that withholding taxes on priority wage claims are constructively due and owing by the bankrupt, it held that the government nevertheless was not required to file a proof of claim. The district court reasoned that, since the purpose of such filing was to apprise the trustee of outstanding claims against the bankruptcy estate, the government was entitled to rely on the claims filed by the employees.

3. We disagree with the holding of the court of appeals that the government's claim for withholding taxes is entitled to second, rather than first, priority status under Section 64(a) of the Bankruptcy Act. In our view, the withholding taxes here constitute expenses of administration entitled to a first priority under Section 64(a)(1) of the Act. See *United States* v. *Fogarty, supra; Lines* v. *California Department of Employment, supra.* The court below rejected this contention on the grounds that withholding taxes do not "relate to the preservation or development of the bankrupt's assets" (Pet. App. A, p. 9a) and that it would be anomalous to accord such taxes a higher priority than the wage claims themselves. The court erred on both grounds.

First, withholding taxes are simply a liability incurred by the trustee in the course of distributing the assets of the estate; like other costs of distributing assets—for example, the salaries of clerical assistants and mailing costs—withholding taxes are a legitimate expense of administering the estate and are therefore entitled to a first priority under Section 64(a)(1) of the Act. Second, according withholding taxes a first priority creates no anomaly; those taxes arise only upon actual payment of the wages and so could never have priority over the wages themselves.

There is, in our view, more basis in the statute for thus treating withholding taxes on priority wage claims as first priority administrative expenses than there is for treating them as second priority items, as the court below has done.[7] The second priority under

---

[7]The importance to the government of a first rather than second priority derives from the fact that after the

Section 64(a)(2) of the Act covers only "wages and commissions." Although withholding taxes in a sense come out of wages, or at least are imposed on account of the payment of wages, that factor alone does not make them wages within the meaning of the statute. Cf. *Joint Industry Board* v. *United States*, 391 U.S. 224.

In any event, the Third Circuit in *Connecticut Motor Lines* erred in treating such withholding taxes as fourth priority items under Section 64(a)(4) of the Act. That priority covers only taxes which were "legally due and owing by the bankrupt" and, as we have shown above (pp. 5-6, *supra*), withholding taxes, such as the ones in issue here, that arise only after the adjudication of bankruptcy were never owed by the bankrupt.

Adoption by the court below of the Third Circuit's approach would have altered the distribution of assets to be made in the present case. For that reason, we believe that this case presents an appropriate occasion for resolution by this Court of the three-way conflict which has now arisen among the courts of appeals with respect to the proper priority to be accorded the government's claims for withholding taxes on priority wage distributions.

---

distribution of wages, but before payment of the taxes, the estate may incur other administrative expenses which, if withholding taxes are not first priority items and were not segregated into a trust fund for the government (see *United States* v. *Randall*, 401 U.S. 513), would have priority over such taxes. In the present case, however, the assets in the estate appear adequate to satisfy the government's claim in full even under the second priority awarded by the court below.

CONCLUSION

For the foregoing reasons, we do not oppose the granting of the petition for a writ of certiorari.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.
SCOTT P. CRAMPTON,
Assistant Attorney General.
CROMBIE J. D. GARRETT,
KARL SCHMEIDLER,
Attorneys.

JANUARY 1974.